Original: September 2, 2010
Revised: September 22, 2010 - Changes reflect revised FY10 investment return for the Educational Retirement Board from 18.6 percent to 18.2 percent.

MEMORANDUM

TO: Representative Luciano "Lucky" Varela, LFC Chair
Legislative Finance Committee Members

FROM: Michelle Aubel, LFC Fiscal Analyst II
Tom Clifford, Chief Economist

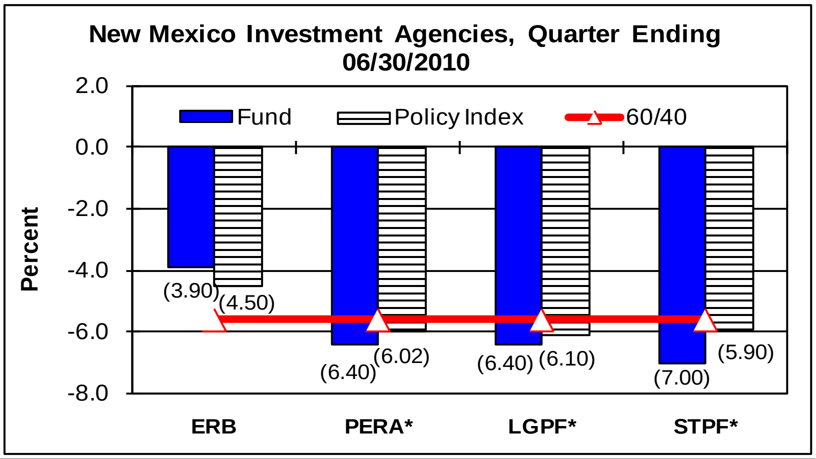
SUBJECT: LFC Report of Investment Performance – 4th Quarter & FY2010 Final

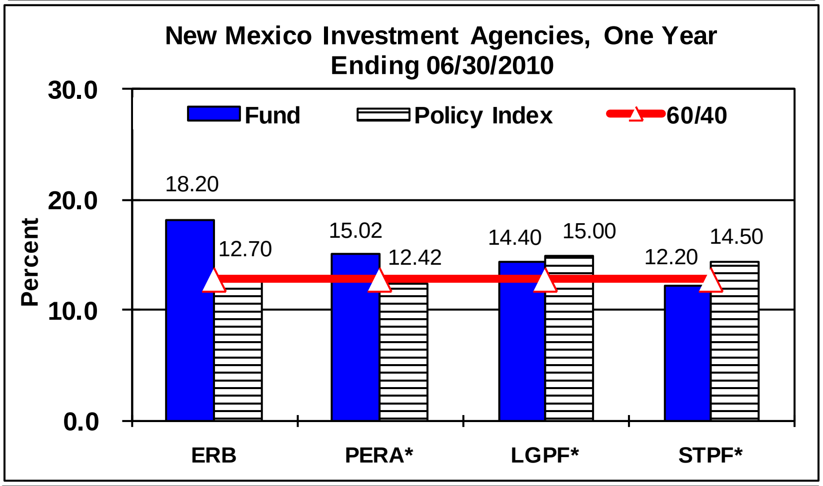
Investment Performance Highlights:

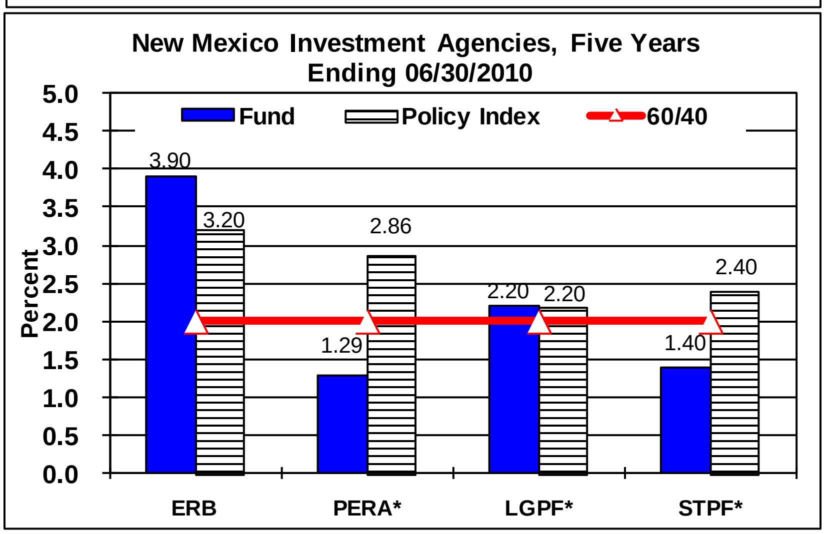
- Negative returns for the fourth quarter trimmed positive results for FY10 for all funds, producing a combined decrease in fund value of $2 billion.
- The quarter's performance cut the substantial recovery of $7.47 billion in total assets reported in March for the rolling 12 months to $3.4 billion for the fiscal year, or 12.5 percent. This includes investment gains as well as contributions and distributions.
- With the lowest loss of -3.9 percent for the quarter, only the Educational Retirement Board (ERB) was able to beat both its internal benchmark and the 60/40 index, a composite of 60 percent US equities and 40 percent core fixed income that yielded a quarterly return of -5.6 percent.
- ERB also significantly outperformed its one-year benchmark by 550 basis points (bps[1]) while the Public Employees Retirement Association (PERA) outpaced its internal target by 260 pbs. Fiscal year results for the two permanent fund managed by the State Investment Council (SIC), the Land Grant and Severance Tax Permanent Funds (LGPF and STPF), continue to lag their respective internal indices.
- While performance for the prior two quarters had been encouraging, improvements in longer-term comparisons remain elusive. ERB has an 70 bps outperformance over its index for the five-year period, and the LGPF has a 30 bps outperformance. PERA and the STPF remain below their indices, underperforming by 157 bps and 80 bps, respectively.
- Although ERB is the only New Mexico fund beating its quarterly, one-year, and five-year benchmarks, the fund's five-year return of 3.9 percent is only half the 8 percent return needed for meeting pension obligations. Even with the year's stellar return, prior-year losses continue to drag down longer-term results below this important target. The 10-year and 15-year returns are 2.6 percent and 6.6 percent, respectively.
- As would be expected, peer rankings improved for ERB – but the 10-year rankings remain low for all agencies (see page 4).

[1] Basis Points (bps) represent a hundredth of one percent. For example, if the LGPF has underperformed its quarterly benchmark by 170 bps, then it has underperformed by 1.7%.

OVERALL FUND PERFORMANCES vs. RELATIVE BENCHMARKS







*Performance includes impacts from "write-downs" in the Securities Lending portfolio.

FUND ASSET VALUES

Total asset values for all funds declined just over $2 billion in the final quarter of FY10, almost wiping out gains accrued during the third and second quarters totaling $2.45 billion. All funds saw quarterly asset declines in excess of 4 percent, with the STPF declining the most by -8.2

percent. The quarter's performance cut the substantial recovery of $7.47 billion in total asset value reported in March for the rolling 12 months to $3.4 billion for the fiscal year, or 12.4 percent, including contributions and distributions as well as investment gains.

Current Asset Values (millions)
For Quarter and Year Ending June 30, 2010

Quarterly	ERB	PERA	LGPF	STPF	TOTAL
Current Asset Values	$8,179	$10,214	$8,846	$3,367	$30,607
Value Change (Previous Quarter)	-$375	-$733	-$650	-$303	-$2,060
Percent Change	-4.4%	-6.7%	-6.8%	-8.2%	-6.3%

Annual	ERB	PERA	LGPF	STPF	TOTAL
Ending Asset Values	$8,179	$10,214	$8,846	$3,367	$30,607
Value Change (Year Ago)	$1,117	$1,157	$918	$188	$3,380
Percent Change	15.8%	12.8%	11.6%	5.9%	12.4%

Reported asset values reflect contributions and distributions in addition to investment returns.

ACTUAL VS. TARGET ASSET ALLOCATIONS

All agencies' actual asset allocations remained relatively close to target levels, with a few exceptions. In response to increased volatility of domestic equity markets, PERA recently adopted new target asset allocations that will reduce this exposure. At its May meeting, the SIC voted to reduce domestic equity exposure from 51 percent to 40 percent while increasing international equities from 10 percent to 15 percent and fixed income exposure from 15 percent to 20 percent. These changes for PERA and SIC are in the process of being implemented and are not yet reflected in the target allocations in the table below.

Fund Asset Allocation Detail, Quarter Ending June 30, 2010

	ERB*		PERA*		LGPF*		STPF*	
	Actual	Target**	Actual	Target**	Actual	Target	Actual	Target
US Equity	26.1%	25.0%	34.4%	35.0%	45.7%	51.0%	42.5%	48.0%
International Equity	17.6%	20.0%	23.8%	25.0%	11.8%	10.0%	14.5%	10.0%
Fixed Income	35.2%	33.0%	26.0%	25.0%	19.4%	15.0%	8.4%	11.0%
Total Alternatives	14.9%	17.0%	15.1%	15.0%	23.0%	24.0%	33.7%	31.0%
Private Equity	3.3%	2.0%	2.6%	2.5%	9.6%	6.0%	16.9%	12.0%
Real Estate/Real Assets	5.5%	5.0%	4.6%	5.0%	3.7%	3.0%	4.8%	3.0%
Absolute Return	6.1%	10.0%	7.9%	7.5%	9.7%	15.0%	7.7%	15.0%
ETI	N/A	0.0%	N/A	0.0%	N/A	0.0%	4.3%	1.0%
Global Asset Allocation	5.4%	5.0%	N/A	0.0%	N/A	0.0%	N/A	0.0%
Cash Equivalents	0.7%	0.0%	0.8%	0.0%	0.2%	0.0%	0.8%	0.0%
Total Fund %	100%	100%	100%	100%	100%	100%	100%	100%

**All funds are reducing exposure to equities and increasing other asset allocations.*

***Due to the long implementation period for some alternatives, both PERA and ERB have adopted interim targets.*

LONG-TERM PERFORMANCE RELATIVE TO PEERS

Peer Percentile Rankings*

	1 Year	5 Year	10 Year
ERB	2	10	74
PERA	23	97	69
LGPF	39	83	79
STPF	58	93	86

* Percentile rankings (1 is highest) for ERB and PERA relative to U.S. Public Funds. Permanent Funds ranked relative to U.S. Endowment Funds.

ERB turned in its best performance relative to peers in FY10 with only one other fund posting a higher return (18.7 percent), significantly improving the 10-year ranking from the 87th percentile to the 74th percentile. Although slipping from March, PERA remains with ERB in the top quartile of U.S. Public Funds from a one-year performance standpoint. This represents a substantial turn-around over the last 12 months, when the fund stood in the 93rd quartile, and can be attributed primarily to better active management. However, ERB still remains the only New Mexico fund to rank higher than 25th for the past five years; all other funds rank well in the last quartile of their peer groups for the five-year period.

ECONOMIC AND FINANCIAL MARKET ENVIRONMENT

The fourth quarter of FY10 saw dramatic upheaval in global financial markets, with public equities experiencing sharp declines and a flight to quality that benefited U.S. Treasuries and other low-risk investments. Domestic equity indices were down sharply, with both the Standard & Poor's 500 Index and the Russell 1000 losing 11.4 percent in the quarter. International equities also lost value, with the developed market index (MSCI EAFE Net) down 14 percent and the emerging market index (MSCI) down 8.4 percent. Twelve month performances for all categories of public equities are still in the black, and range from a 5.9 percent gain (International-developed) to a 24.9 percent gain (S&P Mid Cap 400). Five-year performance of domestic equities is largely negative, as only the S&P Mid Cap 400 showing significant positive returns. International developed market equities rose only slightly over the last five years while emerging market equities were up a strong 12.7 percent per year.

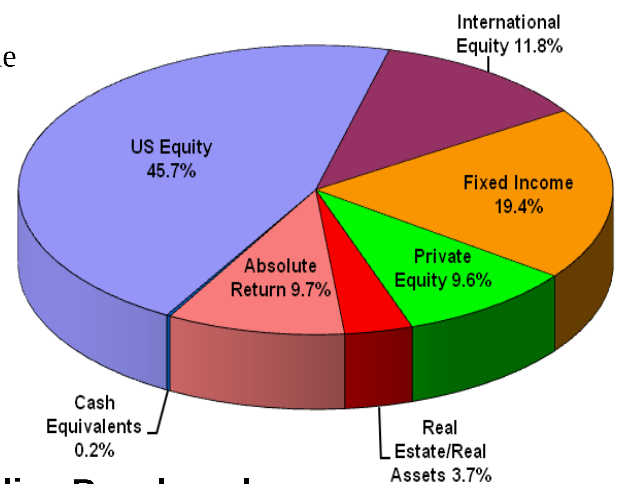
Fixed income indices were mixed in the quarter. Core bonds (Barclay's Aggregate Index) added 3.5 percent for the quarter, bringing gains to 9.5 percent for the past 12 months. High yield indices were off 0.1 percent in the quarter but up 26.8 percent for the year. Commodities were off 4.8 percent in the quarter and 8.4 percent for the year. Real Estate Investment Trusts (REITs) declined 4.2 percent in the quarter but were up 55.5 percent for the year. The Cambridge Venture Capital index, a benchmark for Private Equity investments, was up 0.7 percent in the quarter and 6.6 percent for the year.

The U.S. economy lost momentum in the second quarter of 2010, with GDP growth dropping to 1.6 percent on an annualized basis from the 3.7 percent rate of the first quarter. Consumer spending decelerated, and sales of new and existing homes plummeted after expiration of the federal homebuyers' tax credit. Although exports continue to grow, imports shot up in the second quarter, reducing growth of domestic output. Slowing growth, combined with quiescent inflation, has lead policymakers to begin discussing additional measures to stimulate the economy. Federal Reserve Chairman Bernanke has discussed the possibility of buying long-term bonds in the effort to decrease long-term interest rates. Short-term rates are already near zero, and long-term rates are already at their lowest levels in decades. However, some Fed Board members remain concerned about the potential for inflation when the recovery gains momentum. They note that commercial banks have an estimated $1 trillion of liquid assets available to lend when loan demand picks up.

Land Grant Permanent Fund (LGPF)

Fund Objective: The LGPF is derived from proceeds of sales of state and federal public lands and royalties from mineral and timber production on state lands. The fund is invested by the State Investment Council according to the Prudent Investor Act seeking to preserve capital for future generations of New Mexicans. The fund makes annual distributions to the general fund of 5.8 percent of the average ending balance from the previous five calendar years, which support the operations of public schools and various other beneficiaries

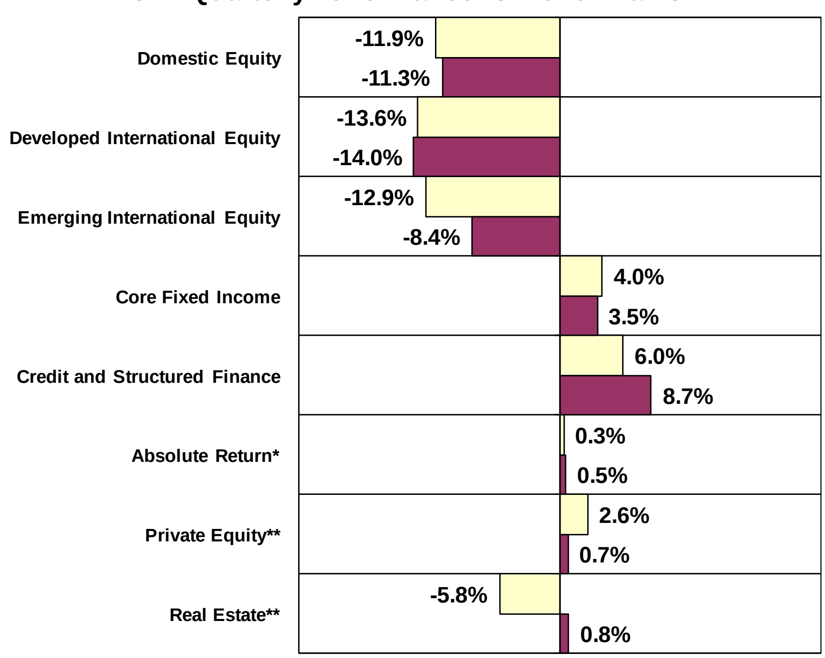
LGPF Asset Allocation as of 6/30/2010



Fund Performance vs. Policy Benchmarks

Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
-6.40%	-6.10%	100	14.40%	15.00%	39	2.20%	2.20%	83

LGPF Quarterly Performance vs. Benchmarks



* Results Lagged One Month
** Results Lagged One Quarter

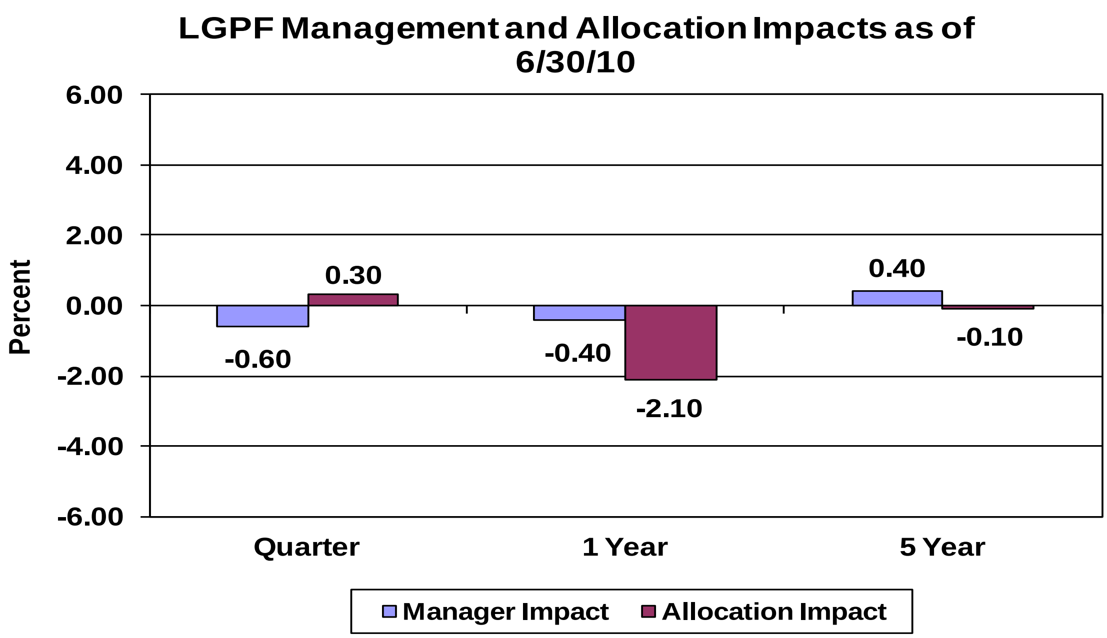
Overview: The LGPF underperformed its quarterly policy benchmark by 30 bps for the quarter and ranked in the 100th – or last – percentile relative to national peers. This performance is a reversal from the preceding two quarters that saw outperformance relative to both benchmarks and peers. Five-year performance of 2.5 percent per year is now slightly better than relative benchmarks. The fund's 10-year return of 2.2 percent equals its policy index, but is still well below the 8.5 percent used to forecast future distributions to the general fund.

During the fourth quarter a majority of the fund's asset classes performed similarly to their relative benchmarks with the following exceptions. Emerging international equity investments yielded a negative 450 bps less than the benchmark. Real estate investments yielded 660 bps less than the benchmark. Since inception the fund's real estate portfolio has achieved an annual return of negative 10.2 percent, which compares to a benchmark return of negative 3.4 percent during the same time period. Credit and structured finance gained 6.0 percent, compared with an 8.7 percent gain by the benchmark.

The domestic equity large cap actively managed pool fell 190 bps below benchmark results in the quarter and 270 bps below benchmark for the year. This pool is still above benchmark results by 350 bps for the five-year period. Although the small/mid cap actively managed pool was slightly above benchmark for the quarter, it fell 460 bps below benchmark for the year.

The core bond portfolio performed well, yielding 60 bps more than the benchmark for the quarter and 110 bps more for the year. Performance on absolute return assets was slightly below benchmark for the quarter, but 430 bps above benchmark for the year.

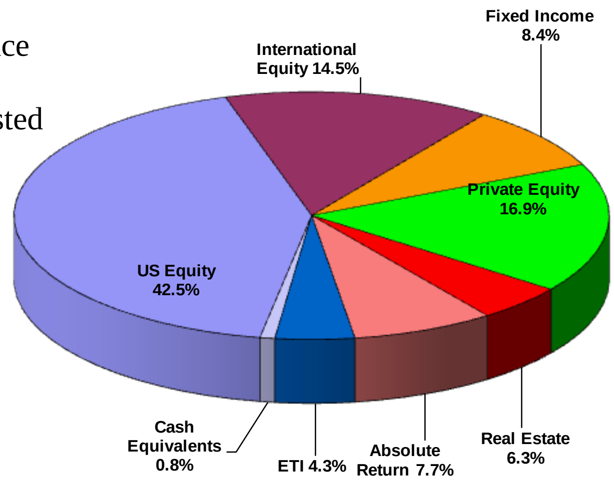
Management and Allocation Impacts: Active management lost 60 bps for the fund in the quarter and 40 bps for the full year. Asset allocation gained the fund 30 bps in the quarter but cost it 210 bps for the full year. The fund's target asset allocation was recently amended, primarily by decreasing its exposure to public equities that were extremely high relative to national peers. The SIC is currently reassessing the fund's long-term allocation policies.



Severance Tax Permanent Fund (STPF)

Fund Objective: The STPF receives contributions from the portion of severance tax proceeds not required for retirement of severance tax bonds. The fund is invested by the state investment council under the Prudent Investor Act seeking to Preserve capital for future generations of New Mexicans. The fund currently makes annual general fund distributions consisting of 4.7 percent of the average ending balance from the previous five calendar years.

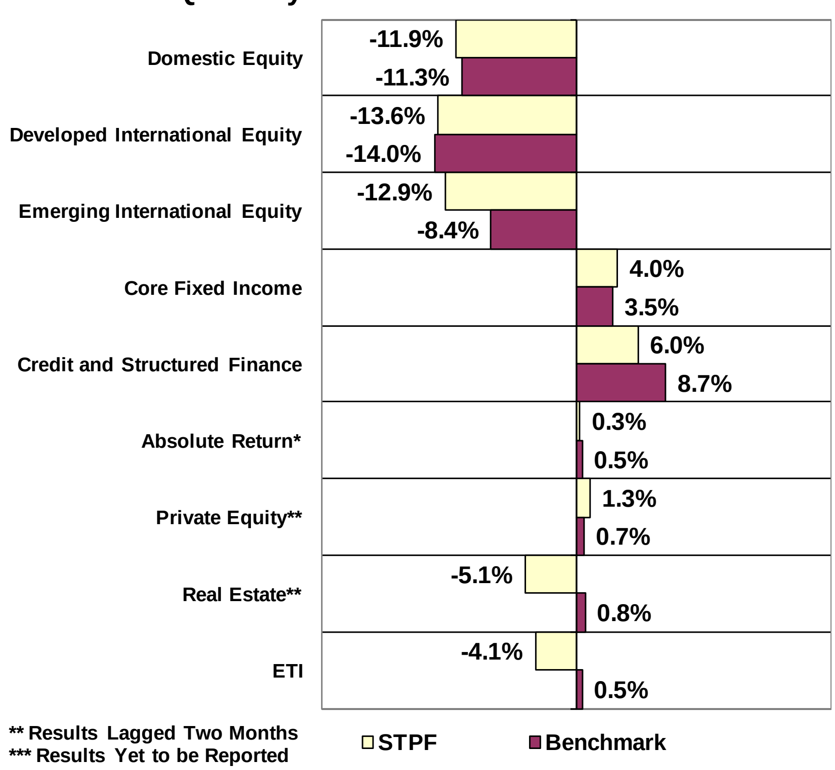
STPF Asset Allocation as of 6/30/2010



Fund Performance vs. Policy Benchmarks

Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
-7.00%	-5.90%	100	12.20%	14.50%	58	1.40%	2.40%	93

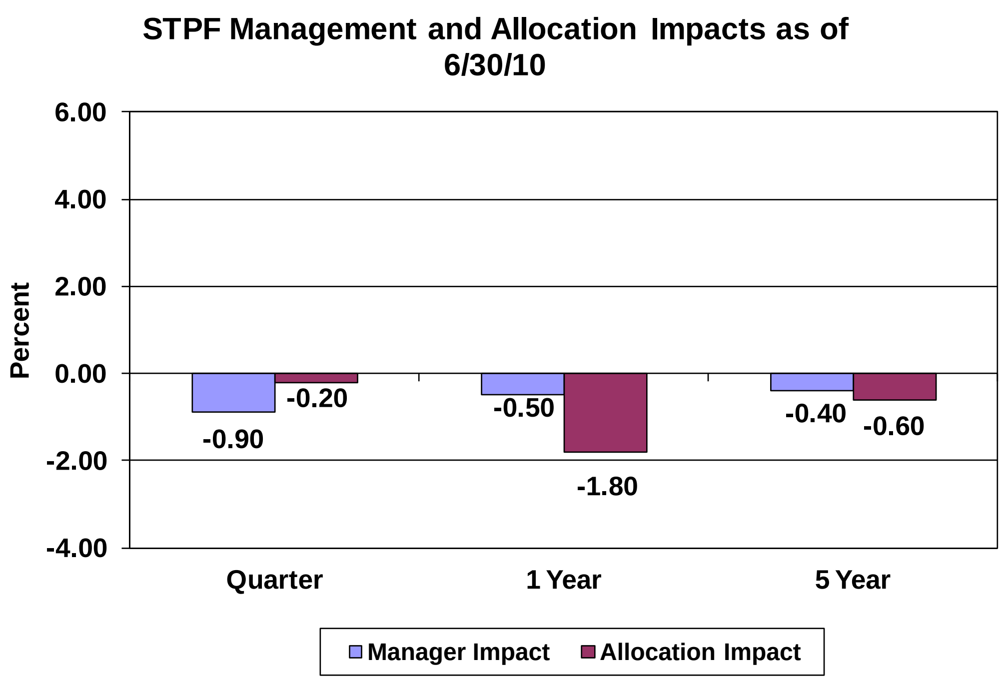
STPF Quarterly Performance vs. Benchmarks



Overview: The STPF underperformed its quarterly policy benchmark by 110 bps and ranked in the last percentile versus its peers. The fund's one-year performance – 230 bps below the policy index -- ranks it in the 58th percentile versus peers and its five-year performance – 100 bps below index -- ranks in the 93rd percentile versus peers. Also the fund's ten-year return of 1.5 percent is still well below all benchmarks including the 8.5 percent used to forecast future distributions to the general fund.

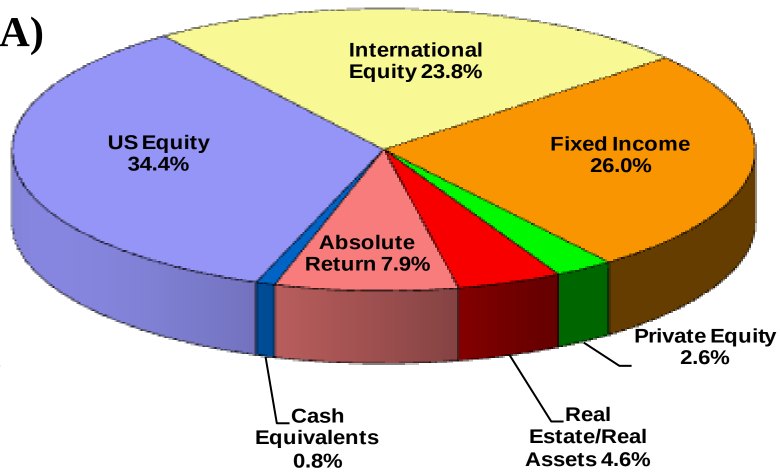
As always, the performance of the STPF was similar to the LGPF with two major exceptions: private equity and economically targeted investments (ETI). Due to various legislative mandates designed to stimulate economic activity within the state, the STPF typically carries a much higher number of alternative investments in its portfolio. Many of these are treated as "differential rate investments," i.e., investments that are not expected to earn a market rate. These statutory directives include the film loan program, the New Mexico Private Equity Investment Program (NMPEIP), and a mandatory investment into the New Mexico Small Business Investment Corporation (SBIC). In fact, the only substantial difference between the asset allocations of the two permanent funds is the inclusion of these investments. Thus as a result of these investments, over the past five years, the STPF has realized annual returns 80 bps below those of the LGPF. Because these funds make annual distributions to the state general fund, this means that the decreased performance of 80 bps has a direct negative effect on state general fund revenues. To date, no adequate study has been done to evaluate the economic stimulus provided from such programs or whether or not such stimulus outweighs the amount of direct general fund revenue forfeited as a result.

Management and Allocation Impacts: Active management cost the STPF 90 bps in the fourth quarter and 50 bps in the full year. Asset allocation cost the fund 20 bps in the quarter and 180 bps in the full year.



Public Employees Retirement Association (PERA)

PERA Asset Allocation as of 6/30/2010



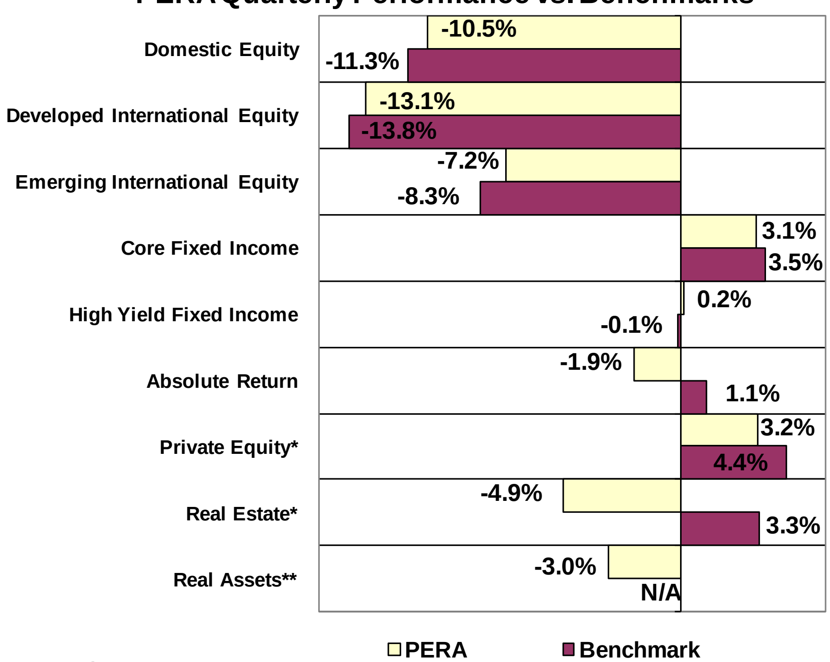
Fund Objective: PERA administers 31 pension plans covering state and local government employees, volunteer firefighters, judges, magistrates and legislators to provide secure retirement. The fund is invested according to the "prudent investor rule" and results are reported in the aggregate. The fund has an 8 percent long-term actuarial benchmark for funding purposes.

Fund Performance vs. Relative Benchmarks*

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
15.02%	12.42%	23	1.29%	2.86%	97	3.60%	3.26%	69
Median Fund Performance		13.81%	Median Fund Performance		3.15%	Median Fund Performance		3.55%

*PERA also has a long-term 8% actuarial benchmark for funding purposes.

PERA Quarterly Performance vs. Benchmarks



* Lagged One Quarter

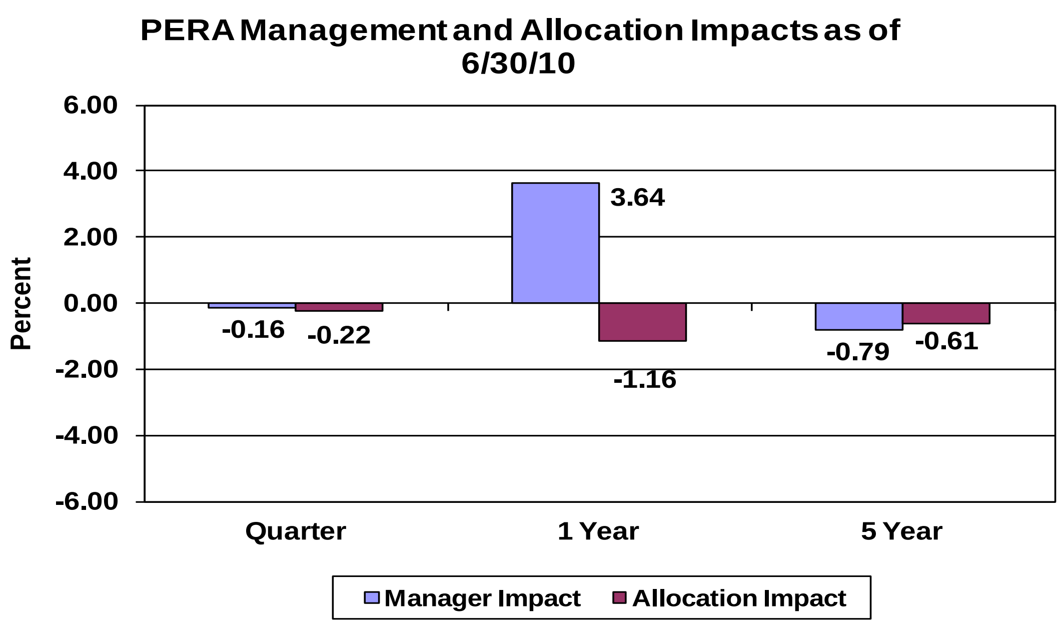
Traditional Assets Gross of Fees, Alternatives Net of Fees

Overview: Reporting a -6.4 percent return for the quarter, PERA underperformed its benchmark slightly by 38 basis points. The quarter's result pushed PERA's one-year peer ranking, which had significantly improved from the 93rd quartile reported a year ago to the 13th quartile last

March, back to the 23rd percentile. The median public fund yielded -4.98 percent for the April through June period. This quarter's performance also dampened recovery efforts achieved during the first three quarters, reducing the one-year return from 37 percent to 15 percent and the five-year return from 3 percent to just over 1 percent. The 15-year return, reported over 8 percent last quarter, once again has slipped under this important benchmark to 7.23 percent.

Asset allocation once again detracted in the fourth quarter with an overweight to equities and underweight to US Treasuries when compared to the better performing peers during this quarter where the "flight to safety" once again played out due to international economic concerns. Only core fixed income and hedge funds posted meaningful positive returns, although both underperformed their respective benchmarks. While all negative, the equity classes came in less negative than their respective benchmarks due to active management. For the fiscal year, the most notable asset performer has been the hedge fund portfolio, up 16.43 percent, which compares favorably to returns reported for its benchmark (4.32 percent), the HFRI Fund-of-Funds Index (4.87 percent), and the S&P 500 Index (14 percent). PERA invests directly in hedge funds rather than hiring fund-of-fund managers.

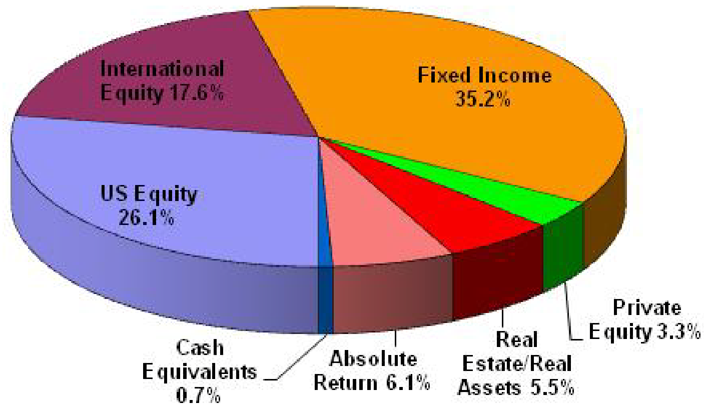
Management and Allocation Impacts: Although slipping in fourth quarter, overall active management for the fiscal year added 364 basis points (bps) to the year's outperformance of 260 bps. Domestic equity and fixed income managers provided the most value. Asset allocation dragged performance down, first through an underweight to emerging markets when that asset class did well earlier in the year and then in the fourth quarter due to a strategic under allocation to US Treasuries. A $75 million "write down" in the securities lending portfolio for FY10 also detracted. As can be seen in the chart below, allocation impacts due to missing upturns in domestic and international equity markets through strategic reductions in 2009, as well as prior manager underperformance, continue to weigh down attributions for the five-year period.



Educational Retirement Board (ERB)

Fund Objective: ERB administers a defined benefit pension plan for public school and higher education employees. The fund is invested according to the "prudent investor rule" to ensure retirement benefits. The fund has an 8% long-term actuarial benchmark for funding purposes.

ERB Asset Allocation as of 6/30/2010

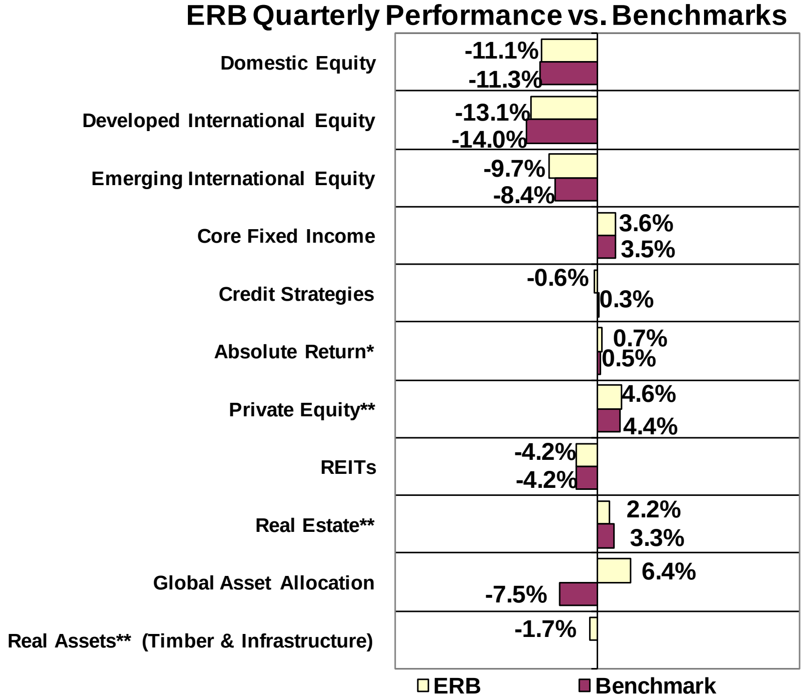


Fund Performance vs. Policy Benchmarks*

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
18.20%	12.70%	2	3.90%	3.20%	10	2.60%	3.00%	74
Median Fund Performance		13.40%	Median Fund Performance		2.70%	Median Fund Performance		3.10%

*ERB also has an 8% actuarial benchmark for funding purposes.

ERB Quarterly Performance vs. Benchmarks



* Results Lagged One Month
** Results Lagged One Quarter

Overview: For FY10 ERB experienced a gross investment gain of $1.2 billion, which includes a gross investment loss of $335.5 million for the last quarter. As predicted last quarter, the fund's lower allocation to equities provided some downside protection during the quarter's negative market although the best performing funds had high allocations to core fixed income. ERB continues to beat its internal benchmark; its 550 bps outperformance for the fiscal year garnered the 2nd percentile position compared to peers. However, the 10-year and 15-year returns stubbornly remain under the 8 percent long-term target at 2.6 percent and 6.6 percent, respectively.

Asset class returns reversed from earlier periods, with domestic equities posting losses across the board. International managers failed to meet their respective indices, particularly in the emerging markets. However, for the fiscal year the emerging equity class earned 25.3 percent and contributed 220 bps of outperformance. Close behind in absolute terms, the fixed income composite returned about 20 percent for the FY10 and provided over 1000 bps of added value. ERB's strategic move to take advantage of stressed credit strategies paid off. As with PERA, ERB's hedge fund portfolio helped anchor a positive return for the year with a 14.4 return versus a fund-of fund index of 5.1 percent. Unique to ERB, the relatively new commitment to the opportunistic global asset allocation also added value, particularly in the fourth quarter, by posting a 6.4 percent gain against its benchmark of -7.5 percent. This performance, in both absolute and relative terms, helped ERB weather the final quarter with the lowest loss of all funds.

Management and Allocation Impacts: Active management added 30 bps for the quarter, and the outperformance for the fiscal year has offset the impact of poor performance assimilated into the five-year computation by 90 bps. Progress was slowed in FY10 by underperformance of active management for domestic equities, leading ERB to terminate large cap managers. The board adopted the recommendation to manage this asset class passively, which is becoming a "best practice" for funds over $5 billion due to the inability to derive excess returns in this efficient market.